

This letter is dated November 2007

China is a threat, China is a customer, and China is an opportunity.¹

- Kenichi Ohmae, former McKinsey & Co. consultant in Japan

American economic and political problems are getting lots of media coverage and will likely receive much more attention in the coming months, providing U.S. investors with no shortage of headlines to worry about. Certainly, the U.S. faces challenges but all may not be as bad as it seems. On the surface faster growing foreign economies and a declining U.S. dollar seem to spell trouble for American companies. A closer look reveals that a growing number of U.S. companies are benefiting significantly from these developments.

Many view China's booming economy as a threat to American economic prosperity. The fact is that Chinese economic growth presents both a negative—incremental competition—and a positive—more potential customers. Some American businesses will lose and some will win. Investors would be wise to consider both foreign competition and foreign opportunities. Businesses generating significant revenue in foreign markets are naturally benefiting from growth in foreign economies. Businesses that are seeking political protection from foreign competition may prove to be casualties of globalization. I believe one should invest in companies playing offense abroad and avoid those that are only able to play defense at home.

A number of U.S. companies are enjoying growing success overseas. America's top 25 public companies derived more than 40% of their revenue from business in foreign countries.² Last year over 50% of Procter & Gamble's revenue came from overseas³ while Exxon generated 69% of its revenue outside the U.S.⁴ The iconic American company Coca-Cola made more than twice as much money selling drinks overseas as it did in the U.S.⁵ And in the rapidly growing emerging markets (e.g. China, Russia, India and Brazil) more than 95% of the personal computers run on Microsoft's operating system.⁶ Economic expansion in foreign countries,

including China, will likely be an important growth driver for successful American businesses and a serious threat to others. Stock price performance so far this year appears to support the growing importance of foreign sales. For the first nine months of 2007 companies within the S&P 500 that derived at least a third of their sales outside of the U.S. showed an average return of almost 15% vs. 6% for all 500 S&P companies (both on an equal weighted basis).⁷

Many are pointing to the decline in value of the U.S. dollar as a clear sign that America itself is in decline. It should be noted, however, that currency exchange rates are not necessarily country report cards. In fact, from 1990 to 1995 the dollar lost about 40% of its value against the Japanese Yen, but during those same years U.S. stocks outperformed Japanese stocks by more than 110%.⁸ While a falling dollar may not be good for the American ego (or the American traveler) it can enhance the competitive position of U.S. companies doing business abroad. A U.S. company selling a product for ten euros in 2001 generated approximately nine U.S. dollars in revenue. Today an American company charging ten euros collects the equivalent of about fourteen dollars— a 56% boost in revenue without any change in price or volume. This puts the U.S. company in an attractive position— it can lower prices in foreign currency terms to gain a competitive advantage or maintain prices and enjoy significantly higher profitability.

In essence, I believe growth is healthier if it is driven globally and not just by the U.S. However, global growth brings both the threats that come from increasing competition and the opportunities that come from more potential customers. Investors in companies that are winning in global competition may do very well in the years ahead. A closer look suggests that many of those winners are likely based in the U.S. where individual and property rights are strongly protected. Despite all the negative news and real problems, the U.S. remains the most technologically advanced and entrepreneurial country in the world.

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¹ Quoted in The World is Flat, Thomas L. Friedman, p.140

² Cit Investment Research and Factset; based on 2006 data

³ Procter & Gamble 10k 6-30-07 p.5

⁴ Exxon 10k 12-31-06 p.79

⁵ Coca-Cola 10k 12-31-06 p.124

⁶ Citi Investment Research

⁷ Citi Investment Research

⁸ Baseline Financial Services

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